CHAPTER III

FUNDING *a* FOUNDATION: WHAT ASSETS TO USE

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Individuals and families of wealth have enthusiastically embraced the idea of creating foundations as a means for pursuing their philanthropic interests. Donors who establish family foundations have a range of options when deciding how to fund their foundations. Often they want to create an endowment. Tax and other considerations come into play, particularly if the donor uses stock in a closely held family business or certain other assets.

DECISIONS ABOUT WHAT ASSETS WILL BE USED to fund a family foundation can be made either at the time that the entity is created or at a later date. Moreover, funding decisions can be slated to take effect upon the death of the donor or another family member. A private foundation may be funded through one contribution or a series of contributions. In most instances, the investment income derived from these gifts is the source of revenue that funds foundation activities. Because few limits are placed on the type, amount, or value of assets that may be used to fund a private foundation, funding for family foundations can come from a wide variety of types of assets, including:

- Liquid assets, such as cash or marketable securities;
- Real estate or tangible property, such as an art collection, jewelry, antique cars, or furniture, that is given with the intention that it will be sold and that the proceeds from the sale will be invested to generate income for grantmaking; or
- An interest in a family enterprise.

What follows is a discussion of assets given to a foundation for investment purposes. Assets given for charitable programmatic purposes—for instance, a family home that is donated as a museum where the family's art collection will be exhibited—do not fall into this category. Many of the great art museums in this country fit this model. The foundations that operate these museums are referred to as operating foundations and the family home and art collection are considered "charitable use assets," rather than investment assets. A discussion of these types of charitable use assets falls outside the scope of this chapter.

Because so few restrictions are placed on the kinds of assets a family foundation may receive, individual families and donors must decide for themselves— within the context of available assets—what assets to donate to the foundation. Such decisions are generally made on the basis of tax law considerations, including income and estate tax charitable contribution laws, and the entire scheme of tax regulations that applies to private foundations. Considering the interplay among these tax rules is important because some affect the individual donor and some place restraints on the foundation.

Understanding how tax laws work and their effect on the kinds of assets given to a foundation is easier when placed in a historical context. Enactment of the Tax Reform Act of 1969 was a defining moment for private foundations in this country. That act provided a clear definition of private foundations, established a set of tax penalties for foundations that engaged in activities prohibited under the act, and specified new annual reporting requirements. Congress enacted the legislation in response to a near 10-year outcry from one of its members to halt abuses by some private foundations. At the time, private foundations were seen as vehicles whereby families of wealth could contribute property to a foundation, receive a charitable deduction, but then continue to control and benefit from the contributed assets. Congress was concerned that without new legislation contributed assets would continue to be used for the private benefit of donors or their families rather than be dedicated to the public purposes for which they were intended. Thus, the contribution deduction for lifetime gifts to private foundations is somewhat restricted and the foundations that receive such gifts are now subject to a number of restrictions.

Constraints on the Donor—Limits on the Charitable Contribution Deduction

Gifts of cash are fully deductible, subject to the following general limitation: A donor's deductions for cash gifts to a foundation may not exceed 30 percent of his or her adjusted gross income in a given year. Lifetime gifts of publicly traded stock that has been held by the donor for more than a year are also deductible. The value of such gifts is the fair market value of the stock at the time of the gift. Annual deductions for such donations may not exceed 20 percent of the donor's adjusted gross income.[15]

Lifetime gifts of closely held stock and tangible property—such as art, furniture, jewelry, and real estate—are deductible only to the extent of the donor's adjusted basis in the property, not the fair market value of the property when donated. Such gifts are also subject to a charitable contribution deduction limit of 20 percent of the donor's adjusted gross income.

In contrast, bequests are fully deductible, at their fair market value at the time of death, and are fully eligible for the estate tax charitable deduction when determining estate taxes. Presumably, Congress believed that because a donor's control over his or her assets ceased at the time of death, no limitation should be placed on the contribution deduction. This means that, in considering the tax consequences of gifts to a foundation, donations of certain types of assets, namely cash and publicly traded securities, make more sense during an individual's lifetime, while others, including stock in a closely held family business, are better given as bequests.

Constraints on Foundations—Cash Requirements

Foundations have cash requirements that must be considered when a donor is determining which of his or her assets to contribute to a foundation. If contributed assets are not sufficient to generate the cash needed to meet those requirements, the foundation may be forced either to sell a portion of those assets to satisfy current needs for cash or to invest in assets that will produce sufficient cash.

Cash requirements are dictated in large part by the provisions of the 1969 act, which were written to ensure that a foundation's assets are used for the charitable purposes of the foundation and the ultimate benefit of the public. Primary among these provisions is the requirement that a foundation pay out an amount equal to 5 percent of the average value of its net investment assets—known as the "minimum distribution" requirement—for charitable purposes each year. Payments that count toward a foundation's minimum distribution requirement (called "qualifying distributions") include grants made by the foundation, administrative expenses incurred in grantmaking, and expenses incurred while conducting direct charitable activities, such as a conference program operated directly by the foundation. A foundation has two years to meet the minimum distribution requirement for any year—that is, it has until the end of year two to distribute the minimum distribution requirement attributable to year one. (See Chapter II, "Developing a Spending Policy," for more details on these requirements.)

A foundation that fails to meets its minimum distribution requirements is subject to an initial excise tax of 15 percent of the amount that has not been distributed. That penalty is followed by a 100 percent tax if the amount is not distributed in a timely manner thereafter.

Congress also imposed an annual 2 percent tax on net investment income—interest, dividends, rents, and royalties. Any net short- or long-term gain from the sale of investments is also subject to this tax. The tax may be reduced to 1 percent if the foundation's qualifying distributions for a tax year exceed a certain percentage of its assets.

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Some foundation expenses do not count toward its minimum distribution requirement—primarily expenses attributable to managing investment assets, such as custodian, brokerage, and investment management fees. These expenses are therefore over and above the amount of cash that the foundation will need to pay the excise tax on its net investment income and to meet its minimum distribution requirement. Thus, a foundation has real cash flow needs that must be considered in determining what assets a donor should contribute and what assets it should continue to hold.

Although the need for cash does not necessarily dictate the types of assets with which a foundation is funded, donors who contribute non-income producing assets, such as their home, to a foundation must understand that, absent sufficient other income-producing assets, the non-income producing assets will have to be sold and the proceeds used to invest in income-producing assets. The time lag between receipt and sale of such assets should also be considered in light of the minimum distribution requirement. Because cash will be needed to meet that requirement and to pay the excise tax on the foundation's net investment income, assets that will be difficult to sell in less than two years are not the best assets to use, unless the foundations has other accessible, liquid assets.

CONSTRAINTS ON FOUNDATIONS—PROHIBITING BENEFITS TO THE DONOR AND THE DONOR'S FAMILY

The 1969 Tax Reform Act was also intended to ensure that donors, their families, and other individuals in positions of trust within private foundations would not receive unfair benefits from those foundations. To that end, prohibitions on "self-dealing" were included in the legislation. The act's self-dealing provisions regulate transactions between a foundation and its "disqualified persons." Disqualified persons include persons such as the foundation's trustees or directors, its officers and their families, substantial contributors to the foundation and their families, and entities, including corporations, partnerships, trusts, and estates in which disqualified persons hold more than 35 percent of the ownership or beneficial interest. Thus, disqualified persons would generally include a closely held family business. (Chapter IV, "Avoiding Conflicts of Interest and Self-Dealing," addresses additional aspects of the self-dealing rules pertaining to investments by foundations and also provides a detailed explanation of disqualified persons and other pertinent self-dealing rules.)

Self-dealing rules are meant to prohibit a disqualified person from receiving any benefit at the expense of the foundation. In establishing these rules, Congress sought to spare the Internal Revenue Service from having to scrutinize every situation to determine whether it was fair to the foundation. Accordingly, it flatly prohibited certain transactions between disqualified persons and a foundation. Many of these rules are arbitrary—so much so that, in some instances, they prohibit transactions that

would benefit the foundation. If a foundation is considering entering into a transaction with a disqualified person—including a closely held family business—or becoming involved with real estate in which family members have an interest, outside legal counsel should be consulted, no matter how harmless the transaction seems.

Self-dealing rules have teeth. Acts of self-dealing are subject to a 5 percent excise tax on the amount involved on the self-dealer for the year in which the self-dealing occurs and for each subsequent year until the self-dealing act is corrected. If the self-dealing act is not corrected in a timely manner, a 200 percent tax may be imposed on the self-dealer. A lesser tax is imposed on any foundation manager— trustees, director, or officer—who knowingly and willfully participates in an act of self-dealing.

Self-dealing rules can also cause problems for a donor who wants to use illiquid assets to fund a foundation, believing that the foundation can then turn around and sell the assets to generate cash to meet the foundation's needs. Unfortunately, the self-dealing rules prevent any sale or exchange between the foundation and a disqualified person. For example, if a donor bequeaths the family residence, jewelry, art, collection of cars, or similar items to a foundation, his or her children are prohibited from buying any of those items from the foundation— even if they have family or sentimental value. Nor can interests in a closely held family business left to a foundation be purchased by a family member—even if that family member offers to pay fair market value or more for the property or interest in the family business. The IRS has even ruled that a disqualified person's purchase at an auction of property owned by a foundation is an act of self-dealing and subjects the purchaser (the "self-dealer") to the self-dealing excise tax.

Self-dealing rules also include other pitfalls. One involves real estate where the subsequent transfer by the foundation to a disqualified person is not a consideration. For instance, when a family member transfers real estate to a private foundation, the transaction is considered a sale if the transferred property is subject to a mortgage or similar lien that the foundation assumes or the debt was placed on the property by a disqualified person during the 10-year period prior to the transfer to the foundation. Thus, all transfers of real estate or tangible property to a foundation should be considered carefully prior to the transaction.

Constraints on Foundations—Limiting Business Holdings

Families that establish private foundations often own and operate successful business enterprises. Family businesses can be convenient sources of income for family foundation grantmaking activities, and are a likely source of a bequest.

Enter the "excess business holdings" rule. When Congress wrote the 1969 Tax Reform Act, it had concerns about the possible abuse of control of charitable assets—that a donor or donor's family might receive a charitable deduction and still perpetuate control of the donated family business through the foundation.

Consequently, the 1969 legislation limits the extent to which a private foundation may own an interest in any business enterprise. This is an arcane and extremely complicated area of tax law.

Specifically, the excess business holdings rule limits how much of a voting interest a private foundation can hold in a business enterprise that is not related to its exempt purposes. A business enterprise is broadly defined to include almost any trade or business. Certain entities are, however, excluded from this definition:

- The first exception is a "functionally related" business. A foundation that is dedicated to grantmaking in the field of education and supports innovative teaching techniques in public schools could create, or acquire, a business that develops software programs for innovative curricula to sell to the school district. Because this business is considered "functionally related" to the foundation's charitable purposes, no restrictions are applied to the size of its holdings in the software company. The foundation could, in fact, hold 100 percent ownership interest.
- A second exception applies to business enterprises that derive 95 percent of their gross income from passive sources, such as dividends, interest, or rent. It is possible to bequeath to a foundation a large interest in a family-owned real estate company if the company's income consists solely of rent from its properties.
- The third exception involves "program-related investments"—investments made by a foundation for a programmatic purpose that relates to its charitable purposes, not primarily for the production of income. An example is a foundation that makes health-related grants and also invests in a startup company that is developing a promising drug to combat a particular disease.

Absent one of these exceptions, the size holdings a private foundation can have in a business enterprise—the "permitted holdings"— depends on the amount of voting stock of the business that is held by "disqualified persons." The *de minimus,* or safe harbor, rule establishes an upper limit on holdings, below which excess business holding provisions do not apply. Under this rule, if a foundation (and other related foundations) holds no more than 2 percent of the voting shares and no more than 2 percent of all classes of stock in a business enterprise, the foundation will not be treated as having excess business holdings, even if all remaining shares are held by a disqualified person. (For purposes of the excess business holdings rule, disqualified persons include: private foundations that are effectively controlled by the same person or persons who control the private foundations in question; and private foundations to which substantially all contributions were made by the same person or persons, or their families, who made substantially all of the contributions to the pri-

vate foundation in question. This rule prevents a donor from creating several private foundations, funding them with stock in a particular company, and then using the foundations to control the company. Thus, the sweep of inclusion and aggregation is broad.)

Beyond the *de minimus* rule, voting stock in a business enterprise held by the foundation and its disqualified persons must be aggregated to determine whether a foundation's ownership position exceeds permitted holdings limitations. In general, private foundations may not hold more than 20 percent of the voting stock of a corporation—including the voting stock owned by all disqualified persons. The foundation can, however, own any amount of nonvoting stock provided that the aggregate of all voting stock held by disqualified persons does not exceed 20 percent of the corporation's voting stock. (The permissible level of holdings increases to 35 percent if effective control of the enterprise rests with one or more persons who are not disqualified persons with respect to the private foundation, and the foundation and all disqualified persons together do not own more that 35 percent of the voting stock of the corporation.)

Direct ownership by a disqualified person is not necessary in computing the holdings of a private foundation or a disqualified person. In general, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. Thus, if any of those individuals is a disqualified person, the stock owned, for instance, by the estate or trust of which they are beneficiaries, must be aggregated as stock owned by the foundation when applying excess business holding rules.

Any foundation that is found to have exceeded its permitted holdings, thereby violating the excess business holdings rule, must dispose of the excess business holdings. Failure to do so will subject the foundation to a 5 percent annual tax on the value of its excess business holdings. Fortunately, foundations that have acquired interests in a business enterprise by gift or bequest have a grace period of five years after the receipt of stock in a business to dispose of excess business holdings before any tax is imposed. Moreover, the IRS may extend that five-year period for another five years if the foundation shows diligent efforts to dispose of the holdings and a plan to do so.

Because of the complexity of the rules regarding excess business, advice from expert legal counsel should be sought by any donor who is considering leaving an interest in a closely held company to a private foundation. Several suggestions of potential ways to dispose of excess business holdings are in the adjoining box.

FAMILY BUSINESSES CAN *be* CONVENIENT SOURCES OF INCOME FOR *family* FOUNDATION GRANTMAKING ACTIVITIES, AND ARE A LIKELY SOURCE *of* A BEQUEST. ENTER THE "EXCESS BUSINESS HOLDINGS" RULE.

Strategies for Disposing of Excess Business Holdings

- The simplest, although not necessarily the most effective, way to dispose of excess business holdings (particularly if the foundation holds a large among of stock) is to give the closely held stock to grantees in lieu of cash. By funding grants in this way, the foundation preserves its liquid assets and reduces its closely held stock holdings. Moreover, the family corporation can buy the stock back from grantees from time to time without violating self-dealing rules. (Before giving stock to grantees, however, any controlling shareholders agreement must be reviewed to determine whether such a grant of stock is permissible.)
- If the closely held corporation is so inclined, it can formulate plans for a public offering and allow the foundation to liquidate some or all of its stock as a part of that process. (This option may not be a feasible or attractive option for many family-held companies.)
- If it has sufficient cash, the closely held corporation can pursue a redemption of its stock. Provided that all shareholders participate on an equal basis, the foundation can tender its stock to the business at that time.
- Depending on the terms of the controlling shareholders' agreement or other restrictions on the stock, the foundation may be able to sell its stock to unrelated third parties. (This solution is the least likely to be available and the most likely to result in a substantial discount on the value of the stock.)

An exception to the self-dealing rule prohibiting a sale or exchange between a foundation and its disqualified persons can be very helpful to a foundation that is looking to dispose of its interests in a family business. Under this exception, a transaction between a foundation and a disqualified person (in this case, the closely held business) is legal if it involves a liquidation, merger, redemption, recapitalization, or other corporate reorganization, and all who hold interests in the enterprise are treated alike. For example, a foundation can sell its shares in a closely held family business to the family business as a part of a redemption program provided that all shareholders are given the same opportunity—even if none of the other shareholders avail themselves of the opportunity.

This exception, coupled with the five-year disposition period, gives donors some flexibility in determining whether to leave some or all of their interests in a family business to a foundation. If the business generates income, the interests bequeathed to the foundation can provide revenue to meet the foundation's cash requirements

and, over five years (or at most, 10 years), if the business has sufficient cash, it can redeem the interests held by the foundation. If the business does not have the wherewithal to redeem the foundation holdings, however, the foundation will have to sell its holdings to non-family members. Such sale can be of concern to family members who own the remaining stock in the business. It is, therefore, important to ascertain in advance whether a bequest of shares in a closely held business will cause the foundation to have excess business holdings and, if so, to devise a plan through which the foundation can dispose of its shares in a manner that benefits both the foundation and the family business.

Summing Up

Although foundations can be funded with any type of assets, the tax consequences—both for the donor and the foundation—of the timing and type of gift should always be considered before making a contribution to the foundation, unless the gift will be in the form of cash or publicly traded securities. The tax deduction allowed a donor may dictate whether making a particular type of contribution is preferable while the donor is living or as a final bequest. How the gift of a non-income-producing property affects the foundation's minimum distribution requirement must be determined—such gifts increase the asset base on which the 5 percent minimum distribution requirement is determined without providing the cash with which to pay out the additional distribution—and a plan that enables the foundation to sell those assets so that the proceeds can be invested in income-producing assets must be developed

Finally, before bequeathing an interest in a closely held business to a foundation, programmatic issues must be addressed, including:

- How the business will be managed and by whom;
- What the foundation's role in managing the business will be, if any; and
- What liabilities the foundation will assume by taking charge of the day-to-day operations of the business.

These same concerns arise, when donating income-producing real estate to a foundation. In that case, although the rental income may be sufficient to meet the 5 percent minimum distribution requirement, the donor and the foundation board must consider a number of other issues in deciding whether to hold or sell the real estate.